

# SUMMARY ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: Wildman and Kuehl Analyst: Jeani Brent Bill Number: AB 358

Related Bills: See Prior Analysis Telephone: 845-3410 Amended Date: 07/01/1999

Attorney: Patrick Kusiak Sponsor:

**SUBJECT:** Refundable Credit/Qualified Wages and Salaries Paid for Production of or Musical Scoring for Qualified Television Program or Motion Picture

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended

X FURTHER AMENDMENTS NECESSARY.

X DEPARTMENT POSITION CHANGED TO Pending.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED February 11, 1999 AND AS AMENDED May 28, 1999 STILL APPLY.

X OTHER - See comments below.

### SUMMARY OF BILL

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would provide a refundable credit equal to 10% of qualified wages and salaries paid to employees and contractors, who are California residents, retained by the taxpayer in connection with the production of or musical scoring for a television program or motion picture for which at least 75% of the total production labor costs or principal photography occur in California.

This bill also would require the department to report annually to the Legislature on the total amount of credits claimed under the bill and would require the Employment Development Department (EDD) to report annually to the Legislature employment data for Standard Industrial Classification Code 781 (relating to motion picture and videotape production). The provisions regarding EDD are not discussed in this analysis.

### SUMMARY OF AMENDMENT

The July 1, 1999, amendments made the credit refundable and changed the sunset date from January 1, 2001, to January 1, 2005. In addition, the amendments would allow the credit for qualified wages and salaries paid in connection with musical scoring for a television program or motion picture and would limit the credit to only those wages paid to employees and contractors who are residents of California. The amendments eliminated the requirement that the production occur entirely in California and instead would require that at least 75% of the total production labor costs or principal photography occur in this state. Finally, the amendments define "qualified wages and salaries" and "qualified motion picture or qualified television program." As part of these definitions, qualified wages and salaries paid in connection with musical scoring sessions would not need to be paid in relation to a qualified television program or qualified motion picture, but would be limited annually to \$1.5 million for a single taxpayer.

### Board Position:

<u>    </u> S	<u>    </u> NA	<u>    </u> NP
<u>    </u> SA	<u>    </u> O	<u>    </u> NAR
<u>    </u> N	<u>    </u> OUA	<u>  X  </u> PENDING

Legislative Director      Date

**Johnnie Lou Rosas      7/12/1999**

The July 1, 1999, amendments would resolve the first policy consideration and all of the implementation considerations addressed in the department's analysis of the bill as amended May 28, 1999. However, the amendments raise additional policy, implementation, and technical considerations. The remaining two policy considerations and the new policy, implementation, and technical considerations are included below.

Except for the items discussed in this analysis and the implementation and policy considerations that were resolved, the department's analyses of the bill as introduced February 11, 1999, and as amended May 28, 1999, still apply.

#### SPECIFIC FINDINGS

**This bill** would provide a refundable credit equal to 10% of qualified wages and salaries paid to employees and contractors hired on or after January 1, 2000, who are California residents, retained by the taxpayer in connection with the production of or musical scoring for a television program or motion picture for which at least 75% of the total production labor costs or principal photography occur in California.

With respect to musical scoring sessions, qualified wages may be paid for a television program or motion picture, regardless of whether that program is a qualified television program or qualified motion picture and are limited to \$1.5 million per taxpayer.

**This bill** would exclude from the definition of "qualified wages" any of the following:

1. Any portion of wages or salary paid that exceeds the lesser of:
  - A. Twice union scale or \$23 per hour but not less than \$300 per day.
  - B. \$7,000 per week.
2. Any legal or accounting fees
3. Any fees or wages paid to managers, agents, or producers.
4. Any cost arising from new-use, reuse, clip use, licensing, secondary markets, delayed or residual compensation, or creation of ancillary products, such as toys.
5. Any fee paid to a composer, songwriter, or music supervisor.
6. Any cost related to computer generated imagery, special digital or optical effects, or any related technological processing.
7. Any costs related to acquisition, development, turnaround, or any rights thereto.
8. Any marketing, promotional, or distribution costs.

**This bill** would define "qualified motion picture or qualified television picture" as any of the following:

1. Movie of the week.
2. Miniseries.
3. Dramatic show or pilot of a dramatic show.
4. Commercial of two minutes or less with a total budget of \$500,000 or more.
5. Motion picture rated by the Motion Picture Association of America.
6. Cartoon animation.

**This bill** also would require the department to report annually to the Legislature on the total amount of credits claimed under the bill and would require the Employment Development Department (EDD) to report annually to the Legislature employment data for Standard Industrial Classification Code 781 (relating to motion picture and videotape production). The provisions regarding EDD are not discussed in this analysis.

#### POLICY CONSIDERATIONS

This bill would raise the following policy considerations.

1. This bill would define qualified wages as only those paid to an employee or contractor who is a California resident. A requirement that an employee reside in California may be subject to constitutional challenge under the Commerce Clause of the United States Constitution. A different method might require that employees be employed in California for the employer to claim the credit.
2. This bill generally would limit the credit to only wages and salaries paid in connection with a "qualified television program or qualified motion picture." However, this bill would not tie wages and salaries paid for musical scoring sessions to a qualified television program or motion picture. Thus, wages and salaries paid for any musical scoring session that involves 25 or more instrumentalists would qualify. However, the bill would limit qualified wages for musical scoring sessions to \$1.5 million for an single taxpayer in any taxable or income year.
3. Conflicting tax policies come into play whenever a credit is provided for an expense item for which preferential treatment already is allowed in the form of an expense deduction or depreciation deduction. This bill would have the effect of providing a double benefit for deductible wages and salaries. On the other hand, making an adjustment to limit deductions or reduce basis in order to eliminate the double benefit creates a state and federal difference, which is contrary to the state's general federal conformity policy.
4. Under this bill, if taxpayers elect to take this credit, it would be in lieu of any other credit allowed for the same costs. However, recent legislation has replaced language requiring taxpayers to make an election for those expenditures with a provision limiting the taxpayer to only one credit with respect to qualified expenditures. This change allows taxpayers to make the choice of which credit to take on either the original or an amended return. This change was made because the requirement for an election, as provided under this bill, was too restrictive. When an election is required, once made, it is binding and generally cannot be revoked. In addition, with an election provision, the failure to make an election generally constitutes an election out of the provision and this "non-election" is binding.

#### IMPLEMENTATION CONSIDERATIONS

This bill raises the following implementation considerations:

1. The provisions regarding wages and salaries that are not included in "qualified wages and salaries" are unclear. The bill states wages and salaries would not qualify to the extent they exceed the lesser of twice union scale or \$23 per hour, but not less than \$300 per day, or \$7,000 per week. This provision leaves unclear how and when each of the given pay scales would interact as limits on the others. Since the three different limiting factors

apparently are intended to apply to different classifications of employees, more detail should be provided to clarify the intended results. For example, it is unclear how \$7,000 could be a limiting factor, when \$23 an hour and \$300 a day are less than that amount.

2. This bill leaves unclear whether taxpayers that are pass-through entities (partnerships, limited liability companies, and S corporations) could claim the credit and receive the refund, or whether the entity must pass through the entire credit to the investors (partners and shareholders), or whether FTB would be required to refund the credit amount in some fashion to both the entity and the investors. Moreover, it is unclear whether, in the case of a pass-through entity, both the entity and the investors would receive the full credit amount. For ease of implementation, this bill should specify that the entire credit amount shall be refunded to the entity that incurred the qualified wages.
3. It could be quite difficult for employers to know the "residence" of employees or contractors.
4. Although previously raised implementation concerns have been addressed, the definitions provided to address these concerns use terms and phrases that appear to be industry-specific terms that have no unambiguous definition under the law, e.g. "new-use," "reuse," "clip use," "delayed or residual compensation," "turnaround," etc. If there's a "dictionary" of motion picture industry terms, it might be helpful to identify a source for these terms.
5. This bill provides no guidance as to whether the refundable credit would be allowed to reduce alternative minimum tax and the \$800 minimum franchise tax to zero. Generally, credits cannot reduce these amounts. The lack of guidance could cause disputes between taxpayers and the department.
6. Although this bill provides that the amount of credit that exceeds tax liability, after all other credits have been subtracted, would be refunded, this bill does not modify the hierarchy of PITL or B&CTL tax credits (Sections 17039 and 23036), thus the order in which credits would be applied before this credit would be refunded is unclear.

#### TECHNICAL CONSIDERATIONS

This bill raises the following technical considerations:

1. The language adding the definition of "qualified wages and salaries" provides that wages can qualify even if paid to a personal service corporation or a loan-out company. The credit language in subdivision (a) refers to "qualified wages and salaries paid to employees and contractors **retained by the taxpayer in connection with. . . .**" Reading these two provisions together, it is arguable that a loan-out company that provides employees or contractors to the actual production company may be properly treated as having "retained" those employees or contractors "in connection with" the production or musical scoring session, with the result that both the actual production company **AND** the loan-out company would **EACH** be entitled to claim this credit with respect to the qualified wages paid (since the credit for the production company would be based on the amounts paid to the loan-out company, even if those amounts are not "wages" within the meaning of the Unemployment Insurance Code).

2. The limitation clause (iv) of subparagraph (B) of paragraph (1) of subdivision (b) on the maximum amount of "qualified wages and salaries" per taxpayer may be unclear as to what happens with respect to wages paid or incurred that are not qualified in the taxable or income year paid. For example, could any wages exceeding the \$1.5 million limitation be treated as qualified wages in the ensuing taxable or income year. Language clarifying the author's intent on this uncertainty would avoid disputes between taxpayers and the department.
3. In subclauses (I) and (II) of clause (iv) of subparagraph (B) of paragraph (1) of subdivision (b), dollar amounts are used to limit the amount of qualified wages. It is not clear whether the author intends to index these amounts for inflation.
4. Subparagraph (A) of paragraph (2) of subdivision (b), requires that a minimum percentage of the total production labor costs be "**incurred in California**" in order for those costs to qualify for this credit. The use of the term "incurred" in this context may indicate a contractual interpretation of that term, rather than a tax law interpretation, which would mean, for example, that if a contract for production labor was executed in California, even if the services are to be performed outside California, the contract might be treated as having satisfied the "incurred in California" standard. It would be better if the amounts in question are required to be treated either as California wages under the UIC or subject to California tax in the case of contract payments.
5. The term "excess" as used in paragraph (1) of subdivision (f) is unclear because of its placement AFTER the "minus other credits" phrase. It is unclear whether the excess also includes the other credits that are limited by the tentative minimum tax. If the term "minus" were replaced by "net of," and the punctuation (commas in particular) were altered, this issue could be clarified, assuming the author only wants the excess unused wage credit to be refundable.

#### FISCAL IMPACT

##### Departmental Costs

Establishing a refundable credit would significantly impact the department's programs and operations since a refundable credit has not existed since the suspension of the refundable renter's credit in 1993, and the department has never administered a refundable bank and corporation tax credit. Assuming that the refund of credits can be handled at the entity level, staff preliminarily estimates that the order of magnitude of the departmental costs would be as shown in the following table:

Franchise Tax Board Order of Magnitude Departmental Costs		
	1999/00	2000/01
Personal Services (approximately 10 personnel years in first year, 2 ongoing)	580,000	133,000
Operating Expense and Equipment	85,000	21,000
Departmental overhead	53,000	12,000
Total	\$718,000	\$154,000

### Tax Revenue Estimate

The revenue impact of this bill is estimated to be as shown in the following table:

Revenue Impact of AB 358, As Amended July 1, 1999 Assumed Enacted after June 30, 1999 \$ Millions			
1999-0	2000-1	2001-2	2002-03
-\$3	-\$49	-\$132	-\$176

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

### Tax Revenue Discussion

The revenue impact of this refundable credit would depend on the amount of qualified wages paid and the tax liabilities of employers claiming this credit.

An estimate for the amount of wages that would qualify under this bill was provided to the department by the Film and Television Action Committee (FTAC). For the year 1998, FTAC estimates that qualified wages approximately would be \$1,429 million, about 12% of the wages paid to California employees in Standard Industry Classification (SIC) code 781 (Motion Picture and Video tape Production).

Data provided by the California Employment Development Department (EDD) reveals that the average annual growth rate of average weekly wages in SIC code 78 was 6.6% for the period 1995 through 1998. This growth rate was used for projecting qualified costs for the out years of this bill. This amount was further discounted to account for the requirement that qualified wages could be paid only to employees or contractors hired on or after January 1, 2000.

The revenue loss for 2000, the first taxable or income year, is projected to be \$65 million as follows:

$\$1,624 \text{ million qualified wages in taxable and income year 2000} * 40\% \text{ adjustment} * 10\% \text{ credit rate} = \$65 \text{ mil.}$

While the total qualified wages for taxable and income 2000 is projected to be \$1,624, many of the employees would have been hired prior to 2000, and thus would not qualify for the credit. It was estimated that only 40% of wages would be paid to employees hired after January 1, 2000. This estimate was derived from two considerations. First, it was assumed that 20% of qualified wages would be for ongoing projects - in particular, continuing television series. Second, it was assumed that of the new projects, 50% of the wages would have been paid to employees who were hired in 1999. Thus, for the 80% of wages paid for projects that are not continuing television series, only 50% would be paid to employees hired after January 1, 2000. ( $0.80 * 0.50 = 0.40$ ). For taxable and income year 2001, all of the wages paid for new projects would be paid to employees hired after

January 1, 2000. It was assumed that a small portion of wages, 4%, would be paid for ongoing projects for which employees had been hired prior to January 1, 2000. The 4% exclusion figure drops to approximately zero by the year 2003.

BOARD POSITION

Pending.

At its March 23, 1999, meeting, the Franchise Tax Board voted 2-0 to take a neutral position on this bill as introduced. The Franchise Tax Board's position for the bill as amended July 1, 1999, is pending.